



[Docket No. OP-1765]

Framework for the Supervision of Insurance Organizations

AGENCY: Board of Governors of the Federal Reserve System (Board).

ACTION: Proposed guidance; request for comments.

SUMMARY: The Board is seeking comment on a new supervisory framework for depository institution holding companies significantly engaged in insurance activities, or supervised insurance organizations. The proposed framework would provide a supervisory approach that is designed specifically to reflect the differences between banking and insurance. Within the framework, the application of supervisory guidance and the assignment of supervisory resources would be based explicitly on a supervised insurance organization's complexity and individual risk profile. The proposed framework would formalize the ratings applicable to these firms with rating definitions that reflect specific supervisory requirements and expectations. It would also emphasize the Board's policy to rely to the fullest extent possible on work done by other relevant supervisors, describing, in particular, the way it will rely more fully on reports and other supervisory information provided by state insurance regulators to minimize the burden associated with supervisory duplication.

DATES: Comments must be received no later than **[INSERT 60 DAYS AFTER DATE OF PUBLICATION IN THE *FEDERAL REGISTER*]**.

ADDRESSES: You may submit comments, identified by Docket No. OP-1765, by any of the following methods:

Agency website: <https://www.federalreserve.gov>. Follow the instructions for submitting comments at <https://www.federalreserve.gov/apps/foia/proposedregs.aspx>.

E-mail: regs.comments@federalreserve.gov. Include docket and RIN numbers in the subject line of the message.

FAX: (202) 452-3819 or (202) 452-3102.

Mail: Ann E. Misback, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW, Washington, DC 20551.

All public comments are available from the Board's website at

<https://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons or to remove personally identifiable information at the commenter's request. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed in-person in Room M-4365A, 2001 C St. NW Washington, DC 20551, between 9:00 a.m. and 5:00 p.m. during federal business weekdays.

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION:

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I. Background

The Board of Governors of the Federal Reserve System (Board) supervises and regulates companies that control one or more banks (bank holding companies) and companies that are not bank holding companies that control one or more savings associations (savings and loan holding companies, and together with bank holding companies, depository institution holding companies). Congress gave the Board regulatory and supervisory authority for bank holding companies through the enactment of the Bank Holding Company Act of 1956 (BHC Act).¹ The Board's regulation and supervision of savings and loan holding companies began in 2011 when provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)² transferring supervision and regulation of savings and loan holding companies from the Office of Thrift Supervision to the Board took effect.³ Upon this transfer, the Board became the federal supervisory agency for all depository institution holding companies, including a portfolio of savings and loan holding companies significantly engaged in insurance activities (supervised insurance organizations).⁴

The Board has a long-standing policy of supervising holding companies on a consolidated basis. Consolidated supervision encompasses all legal entities within a holding company structure and supports an understanding of the organization's complete risk profile and its ability to address financial, managerial, operational, or other deficiencies before they pose a

¹ Ch. 240, 70 Stat. 133.

² Pub. L. 111-203, 124 Stat. 1376 (2010).

³ Dodd-Frank Act tit. III, 124 Stat. at 1520–70.

⁴ Although currently all supervised insurance organizations are savings and loan holding companies, the proposed framework would apply to any depository institution holding company that meets the criteria of a supervised insurance organization.

danger to its subsidiary depository institution(s). The Board's current supervisory approach for noninsurance depository institution holding companies assesses holding companies whose primary risks are related to the business of banking. The risks arising from insurance activities, however, are materially different from traditional banking risks. The top-tier holding company for some supervised insurance organizations is an insurance underwriting company, which is subject to supervision and regulation by the relevant state insurance regulator as well as consolidated supervision from the Board; for all of these firms, the state insurance regulators supervise and regulate the business of insurance underwriting companies. Additionally, instead of producing consolidated financial statements based on generally accepted accounting principles, many of these firms only produce legal entity financial statements based on Statutory Accounting Principles (SAP) established by states through the National Association of Insurance Commissioners (NAIC).

In view of these differences, the Board has sought to tailor its supervision and regulation of supervised insurance organizations. For example, in 2013, when the Board implemented the Basel III capital standard in the United States, the Board determined not to apply it to this group of companies, stating that it would “explore further whether and how the proposed rule should be modified for these companies in a manner consistent with section 171 of the Dodd-Frank Act and safety and soundness concerns.”⁵ In 2019, the Board invited comment on a proposal to establish a risk-based capital framework designed specifically for supervised insurance organizations, termed the Building Block Approach, that would adjust and aggregate existing legal entity capital requirements to determine an enterprise-wide capital requirement.⁶ In addition, in 2018, the Board did not apply to these firms the supervisory rating systems

⁵ Regulatory Capital Rules: Implementation of Basel III, 78 FR 62017, 62027 (October 11, 2013).

⁶ Regulatory Capital Rules: Risk-Based Capital Requirements for Depository Institution Holding Companies Significantly Engaged in Insurance Activities, 84 FR 57240 (October 24, 2019).

applicable to other depository institution holding companies.⁷ As described in the Supplementary Information, the proposed supervisory framework (proposal) represents a significant step in the continuation of the Board's tailored approach to supervision and regulation for supervised insurance organizations.

II. Summary of the Proposal

The proposal would establish a transparent framework for consolidated supervision of supervised insurance organizations. A depository institution holding company is considered to be a supervised insurance organization if it is an insurance underwriting company or if over 25 percent of its consolidated assets are held by insurance underwriting subsidiaries. The proposed framework is designed specifically to account for the unique risks and business profiles of supervised insurance organizations resulting mainly from their insurance business. The framework consists of a risk-based approach establishing supervisory expectations, assigning supervisory resources, and conducting supervisory activities; the formalization of a supervisory rating system; and a description of how examiners would work with state insurance regulators to limit the burden associated with supervisory duplication.

A. Proportionality

The proposed supervisory framework describes a supervisory approach that is proportional to the risks of each supervised insurance organization. This approach is designed to address the unique features of insurance activities and thereby not replicate the standards for the supervision of banking activities. The proposed supervisory framework would result in supervisory activities and the application of supervisory guidance that look beyond the size of the institution and instead focus on the material risks that could pose a threat to the

⁷ See Large Financial Institution Rating System; Regulations K and LL, 83 FR 58724 (November 21, 2018); Application of the RFI/C(D) Rating System to Savings and Loan Holding Companies, 83 FR 56081 (November 9, 2018).

organization's safety and soundness and, in particular, its ability to serve as a source of strength for its depository institution(s).

To achieve this, Federal Reserve staff would first classify supervised insurance organizations as either complex or noncomplex based on their risk profile. Supervisory activities would vary based on this determination and also based on each firm's individual risk profile. Complex supervised insurance organizations have a higher level of risk and therefore require more frequent and intense supervisory attention. Noncomplex supervised insurance organizations, due to their lower risk profile, require less intense supervisory oversight. In making this classification, the Federal Reserve would consider at least the factors listed in the proposal, which include: quality and level of capital and liquidity, size of its depository institution(s), organizational structure, unregulated and/or unsupervised activities, international exposure, product and portfolio risks, supervisory ratings and opinions, and interconnectedness.

Riskier firms would be classified as complex, which would result in the assignment of a dedicated team responsible for consolidated supervision of the organization. Complex firms would be subject to routine continuous monitoring and targeted examinations as necessary to properly understand and assess the firm. Less risky firms would be classified as noncomplex. Noncomplex firms would be subject to an annual examination to assess the firm and assign ratings. This approach make it possible for a firm with over \$100 billion in total assets to be classified as noncomplex if, for example, most of those assets were a result of traditional insurance activities, it had a small depository institution, it had a history of maintaining relatively large capital and liquidity buffers, and it was viewed overall as well run with little risk to its depository institution. Supervisory activities would also be adapted among complex firms to reflect the actual risk profile of the firm and to focus on risks that are most likely to threaten the holding company's ability to act as a source of strength for its depository institution(s).

Applicable practices, as described in supervisory guidance, that are consistent with the Board's expectations for organizations operating in a safe and sound manner, would also vary

based on the complexity classification and based on each firm's risk profile. The firm's risk profile would be reassessed by the Federal Reserve annually and Federal Reserve examiners would inform the firm if different supervisory guidance had become more relevant as a result of a material change to the firm's risk profile.

Question 1. What additional factors, if any, should the Board consider when considering the complexity of supervised insurance organizations?

Question 2. What other considerations beyond those outlined in this proposal should be considered in the Board's assessment of whether a supervised insurance organization has sufficient financial and operational strength and resilience to maintain safe and sound operations?

Question 3. What additional clarity, if any, is needed to describe the supervisory guidance related to the evaluation of a firm's governance and controls, capital management, and liquidity management under the proposed framework?

Question 4. What additional differences exist between supervised insurance organization and bank holding companies that should be considered and reflected in the framework? What additional measures, if any, could the Board take to appropriately tailor its approach to supervising these firms?

B. Ratings

Since 2011, supervised insurance organization have been assigned indicative ratings under the Board's RFIC/(D) framework (RFI framework).⁸ The proposal would establish a unique supervisory rating system that, if adopted, would replace the indicative RFI ratings for all

⁸ SR 19-4: Supervisory Ratings System for Holding Companies with Total Consolidated Assets Less Than \$100 billion, <https://www.federalreserve.gov/supervisionreg/srletters/sr1904.htm>.

supervised insurance organizations. Under the proposed framework, firms would be rated annually in each of three components: Capital Management, Liquidity Management, and Governance and Controls. Firms would be assigned one of four ratings for each of the three components. The ratings are Broadly Meets Expectations, Conditionally Meets Expectations, Deficient-1, and Deficient-2 and would reflect how consistent a firm's practices are with the Board's expectations for safe and sound operations. As described above, despite rating the same components for all supervised insurance organizations and using the same ratings, applicable supervisory guidance would be based on each firm's specific risk profile and would vary significantly between the smallest, least risky firms and the largest, riskiest firms. The proposed ratings are modeled after the LFI framework, although they have been modified in structure and application to support their use for supervised insurance organizations of all sizes and risk profiles. For example, instead of emphasizing in the rating components and definitions the importance of continuing to serve as a financial intermediary under stress, the proposal stresses the obligation that supervised insurance organizations operate in a safe and sound manner and serve as a source of financial and managerial strength for their depository institution(s).

Question 5. What additional clarity, if any, is needed to describe the ratings process, including the ratings definitions?

Question 6. Should the final framework include a composite rating?

C. Incorporating the work of other supervisors:

Effective consolidated supervision requires collaborative relationships with all relevant supervisors and regulators. The Board respects the individual statutory authorities and responsibilities of other supervisors and regulators and works to develop appropriate information flows and coordination so that each supervisor's responsibilities can be carried out effectively while limiting the burden associated with supervisory duplication. In developing its overall assessment of a supervised insurance organization, the proposed framework emphasizes the

importance of these relationships and that Federal Reserve examiners rely to the fullest extent possible on information available from, and examination reports by, other relevant supervisors and regulators. Because supervised insurance organizations have material insurance business lines, the proposed framework describes how the Federal Reserve would leverage the work done by the state insurance regulators, including examples of specific insurance supervisory reports that will be used as input into the Federal Reserve's assessment and ratings. With respect to the business of insurance, the Board specifically leaves to the state insurance regulators the oversight of pricing and reserving of insurance liabilities.

Question 7. What additional measures, if any, should the Board take to fulfill its goal to rely to the fullest extent possible on work of other relevant supervisors, including the state insurance regulators?

III. Applicability, Timing, and Implementation

Federal Reserve examiners would use the proposed framework as their basis for the supervision of insurance organizations. A depository institution holding company is considered to be a supervised insurance organization if it is an insurance underwriting company or if over 25 percent of its consolidated assets are held by insurance underwriting subsidiaries. Other depository institution holding companies can also be designated as supervised insurance organizations if Federal Reserve staff decides, based on the firm's risk profile, that doing so would result in more effective supervision.

The Board proposes that the Federal Reserve would classify supervised insurance organizations as complex or noncomplex and initial ratings during the calendar year in which the final framework becomes effective. Due to differences in the timing of supervisory cycles across the portfolio, firms may receive their initial ratings at different times during the year.

Consistent with current Federal Reserve practice on the assignment and communication of supervisory ratings by examiners, ratings under the proposed framework would be assigned and communicated to firms on an annual basis, and more frequently as warranted. In accordance with the Board's regulations governing confidential supervisory information, ratings assigned under the proposed framework would be communicated by the Federal Reserve to the firm but not disclosed to other persons except in accordance with the Federal Reserve Act and the Board's Rules Regarding Availability of Information.⁹

Question 10. What additional clarity, if any, is needed to describe which firms would be subject to the proposed framework?

IV. Regulatory Analysis

Paperwork Reduction Act

There is no collection of information required by this proposal that would be subject to the Paperwork Reduction Act of 1995, 44 U.S.C. 3501 *et seq.*

⁹ 12 U.S.C. 326; 12 CFR part 261.

V. Proposed Text of the Supervisory Framework

This framework describes the Federal Reserve’s approach to consolidated supervision of supervised insurance organizations.¹ The framework is designed specifically to account for the unique risks and business profiles of these firms resulting mainly from their insurance business. The framework consists of a risk-based approach to establishing supervisory expectations, assigning supervisory resources and conducting supervisory activities; a unique supervisory rating system; and a description of how Federal Reserve examiners will work with the state insurance regulators to limit the burden associated with supervisory duplication.

A. Proportionality – Supervisory Activities and Expectations

Consistent with the Federal Reserve’s approach to risk-based supervision, supervisory guidance will be applied and supervisory activities will be conducted in a manner that is proportionate to each firm’s individual risk profile. This begins by classifying each supervised insurance organization as either complex or noncomplex based on their risk profile and continues with a tailored application of supervisory guidance and supervisory activities. Federal Reserve supervisory teams will conduct a risk assessment each year based on their current understanding of the firm’s risks. Any change in the risk assessment will be communicated to the firm’s board and senior management, along with potential implications to the relevance of certain expectations communicated through supervisory guidance². The risk assessment also drives supervisory activities, which will be focused on resolving supervisory knowledge gaps, monitoring the safety and soundness of the firm, and assessing the firm’s management of risks that could potentially impact its ability to act as a source of managerial and financial strength for its depository institution(s).

1. Complex and Noncomplex Supervised Insurance Organizations

¹ In this framework, a “supervised insurance organization” is a depository institution holding company that is an insurance underwriting company, or that has over 25 percent of its consolidated assets held by insurance underwriting subsidiaries, or has been otherwise designated as a supervised insurance organization by Federal Reserve staff.

² This could happen if a firm’s risk profile changes significantly and typically follows a strategic change for the firm (a material acquisition, divestiture, or product offering change).

Each supervised insurance organization is classified by the Federal Reserve as either complex or noncomplex based on its risk profile. The classification serves as the basis for determining the level of supervisory resources dedicated to each firm, as well as the frequency and intensity of supervisory activities.

Complex: Complex firms have a higher level of risk and therefore require more frequent and intense supervisory attention. Federal Reserve dedicated supervisory teams are assigned to execute approved supervisory plans led by a dedicated Central Point of Contact. The activities listed in the supervisory plans focus on understanding any of a firm's risks that could threaten the safety and soundness of the consolidated organization or a firm's ability to act as a source of strength for its depository institution(s). These activities typically include continuous monitoring, targeted topical examinations, coordinated reviews, and an annual roll-up assessment resulting in ratings for the three rating components. The focus, frequency, and intensity of supervisory activities are based on the firm's unique risk profile and, therefore, can vary among complex firms. The relevance of certain supervisory guidance also may vary among complex firms based on each firm's unique risk profile. Supervisory guidance targeted at smaller bank holding companies, for example, may be more relevant for complex supervised insurance organizations with limited inherent exposure to a certain risk.

Noncomplex: Noncomplex firms, due to their lower risk profile, require less supervisory oversight relative to complex firms. The supervisory activities for these firms occur primarily during an annual full-scope inspection resulting in the assignment of the three component ratings. The supervision of noncomplex firms relies more heavily on the reports and opinions of a firm's other relevant supervisors, although these firms are subject to continuous monitoring and coordinated reviews as appropriate. The focus and types of supervisory activities for noncomplex firms are also set based on the unique risks of each firm.

Factors considered when classifying a supervised insurance organization as either complex or noncomplex include the organization's quality and level of capital and liquidity, the size of its depository institution, the complexity of its organizational structure, the nature and extent of any unregulated and/or unsupervised activities, any

international exposure³, its product and portfolio risks, ratings and opinions from its regulatory supervisors, and its potential interconnectedness with the broader financial system.

For supervised insurance organizations that are new to Federal Reserve supervision, the classification as complex or noncomplex is done and communicated during the application phase after initial discussions with the firm. The firm's risk profile, including the characteristics listed above, and the proposed classification are vetted and decided by staff at the relevant Reserve Bank and the Board. Large, well-established, and financially strong supervised insurance organization with relatively small depository institutions can be classified as noncomplex if Federal Reserve staff considers the corresponding level of supervisory oversight sufficient to accomplish its objectives. Although the risk profile is the primary basis for determining a firm's classification, a firm is automatically classified as complex if its depository institution's average assets exceed \$100 billion.

2. Supervisory Expectations

Supervised insurance organizations are expected to operate in a safe and sound manner, to comply with all applicable laws and regulations, and to possess sufficient financial and operational strength to serve as a source of strength for their depository institution(s) through a range of stressful yet plausible conditions. The management and risk management practices necessary to meet these expectations will vary based on a firm's specific risk profile and will vary significantly between the smallest, least risky firms and the largest, riskiest firms. Guidance describing supervisory expectations for safe and sound practices can be found in Supervision & Regulation (SR) letters published by the Board and other supervisory material. Supervisory guidance most relevant to a specific supervised insurance organization is driven by the unique risk profile of the firm. The firm's risk profile is reassessed by the Federal Reserve annually. Federal Reserve examiners will inform the firm if different supervisory guidance becomes more relevant as a result of a material change to the firm's risk profile. This is typically only the result of a significant business decision,

³ Supervised insurance organizations designated by their Group-Wide Supervisor as an Internationally Active Insurance Group (IAIG) are classified as complex.

like an acquisition, divestiture, or change to the firm's product offering or asset portfolio. This section describes general safety and soundness expectations and how the Board has adapted its supervisory expectations to reflect the unique characteristics of supervised insurance organization. The section is organized using the three rating components for – Governance and Controls, Capital Management, and Liquidity Management.

a. Governance and Controls

The Governance and Controls rating is derived from an assessment of the effectiveness of a firm's (1) board and senior management effectiveness, and (2) independent risk management and controls. All firms are expected to align their strategic business objectives with their risk appetite and risk management capabilities; maintain effective and independent risk management and control functions including internal audit; promote compliance with laws and regulations; and remain a source of financial and managerial strength for their depository institution(s). When assessing governance and controls, Federal Reserve examiners consider a firm's risk management capabilities relative to its risk exposure within the following areas: internal audit, credit risk, legal and compliance risk, market risk, model risk, and operational risk, including cybersecurity/information technology and third party risk.

Governance & Controls expectations:

- Despite differences in their business models and the products offered, insurance companies and banks are expected to have effective and sustainable systems of governance and controls to manage their respective risks. The G&C framework for a supervised insurance organization should:
 - Clearly define roles and responsibilities throughout the organization;
 - Include policies and procedures, limits, requirements for documenting decisions, and decision-making and accountability chains of command; and
 - Provide timely information about risk and corrective action for non-compliance or weak oversight, controls, and management.
- The Board expects the sophistication of the G&C framework to be commensurate with the size, complexity, and risk profile of the firm. As such, G&C expectations for complex firms will be higher than that for noncomplex firms but will also vary based on each firm's unique risk profile.

- The enhanced prudential standards rule under Regulation YY⁴ is not applicable to supervised insurance organizations. Unlike large banking organizations, these firms are not required by regulation to maintain a risk committee that periodically reviews and approves the risk management policies of the firm's operations and oversees the operation of its risk management framework, nor are they required by regulation to have a chief risk officer. The Board expects supervised insurance organization to have a risk management and control framework that is commensurate with their structure, risk profile, complexity, activities, and size. For any chosen structure, the firm's board is expected to have the capacity, expertise, and sufficient information to discharge risk oversight and governance responsibilities in a safe and sound manner. The chief risk officer facilitates an enterprise-wide approach to the identification and management of all risks across the organization and while the designation of a chief risk officer is not required, most large insurance companies have found value in having an independent chief risk officer. The Board cautions boards that they may be susceptible to undue risk and responsibility without a truly independent chief risk officer, which may result in safety and soundness concerns, particularly with complex firms, for whom the Board may require the designation of an independent chief risk officer. Firms that do not have a designated chief risk officer should have sufficient compensating controls in place to ensure that the head of risk management has adequate independence and stature to provide effective challenge. Likewise, the Federal Reserve may require a firm's board to establish a risk committee if it is not clear that the current board structure provides sufficient oversight of the firm's risk management framework and practices.

In assigning a G&C rating, Federal Reserve examiners evaluate:

- **Board and Senior Management Effectiveness** – The firm's board is expected to exhibit certain attributes consistent with effectiveness, including: (i) setting a clear, aligned, and consistent direction regarding the firm's strategy and risk appetite; (ii) directing senior management regarding board reporting; (iii) overseeing and holding senior management accountable; (iv)

⁴ 12 CFR part 252.

supporting the independence and stature of independent risk management and internal audit; and (v) maintaining a capable board and an effective governance structure. As the consolidated supervisor, the Board focuses on the board of the supervised insurance organization and its committees. Complex firms are expected to take into consideration the Board's guidance on board of directors' effectiveness.⁵ In assessing the effectiveness of a firm's senior management, Federal Reserve examiners consider the extent to which senior management effectively and prudently manages the day-to-day operations of the firm and provides for ongoing resiliency; implements the firm's strategy and risk appetite; identifies and manages risks; maintains an effective risk management framework and system of internal controls; and promotes prudent risk taking behaviors and business practices, including compliance with laws and regulations such as those related to consumer protection and the Bank Secrecy Act/Anti-Money Laundering and Office of Foreign Assets Control (BSA/AML and OFAC). Federal Reserve examiners evaluate how the framework allows management to be responsible for and manage all risk types, including emerging risks, within the business lines. Examiners rely to the fullest extent possible on insurance and bank supervisors' examination reports and information concerning risk and management in specific lines of business, including relying specifically on state insurance regulators to evaluate and assess how firms manage the pricing, underwriting, and reserving risk of their insurance operations.

- **Independent Risk Management and Controls** - In assessing a firm's independent risk management and controls, Federal Reserve examiners consider the extent to which independent risk management effectively evaluates whether the firm's risk appetite framework identifies and measures all of the firm's risks; establishes appropriate risk limits; and aggregates, assesses and reports on the firm's risk profile and positions. Additionally, the firm is expected to demonstrate that its internal controls are appropriate and tested for effectiveness and sustainability.

⁵ SR 21-3: Supervisory Guidance on Board of Directors' Effectiveness, <https://www.federalreserve.gov/supervisionreg/srletters/SR2103.htm>.

- **Internal Audit** is an integral part of a supervised insurance organization's internal control system and risk management structure. An effective internal audit function plays an essential role by providing an independent risk assessment and objective evaluation of all key governance, risk management, and internal control processes. Internal audit is expected to effectively and independently assess the firm's risk management framework and internal control systems, and report findings to senior management and to the firm's audit committee. Despite differences in business models, the Board expects the largest, most complex supervised insurance organizations to have internal audit practices in place that are similar to those at banking organizations and as such, no modification to existing guidance is required for these firms.⁶ At the same time, the Board recognizes that firms should have an internal audit function that is appropriate to their size, nature, and scope of activities. Therefore, for noncomplex firms, Federal Reserve examiners will use the expectations in the insurance company's domicile state's Annual Financial Reporting Regulation (NAIC Model Audit Rule 205), or similar state regulation, to assess the effectiveness of a firm's internal audit function.

The principles of sound risk management described in the previous sections apply to the entire spectrum of risk management activities of a supervised insurance organization, including but not limited to:

- **Credit risk**, which arises from the possibility that a borrower or counterparty will fail to perform on an obligation. Fixed income securities, by far the largest asset class for insurance companies, is the largest source of credit risk. This is unlike banks, where loans generally make up the largest portion of balance sheet assets. Life insurer investment portfolios in particular are generally characterized by longer duration holdings compared to those of banks. Additionally, an insurance company's reinsurance recoverables/receivables arising from the use of third-party reinsurance and

⁶ Regulatory guidance provided in SR 03-05 *Amended Interagency Guidance on the Internal Audit Function and its Outsourcing*, <https://www.federalreserve.gov/boarddocs/srletters/2003/sr0305.htm> and SR 13-1 *Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing*, <https://www.federalreserve.gov/supervisionreg/srletters/sr1301.htm>, are applicable to complex supervised insurance organizations only.

participation in regulatory required risk-pooling arrangements expose the firm to additional counterparty credit risk. The Federal Reserve will scope examination work based on a firm's level of inherent credit risk. The level of inherent risk will be determined by analyzing the composition, concentration, and quality of the consolidated investment portfolio; the amount of a firm's reinsurance recoverables and the credit quality of the individual reinsurers; and credit exposures associated with derivatives, securities lending, or other activities that may also have off-balance sheet counterparty credit exposures. In determining the effectiveness of a firm's management of its credit risk, Federal Reserve examiners will rely, where possible, on the assessments made by other relevant supervisors for the bank and the insurance companies. In its own assessment, the Federal Reserve will determine whether the board and senior management have established an appropriate credit risk governance framework consistent with the firm's risk appetite; whether policies, procedures and limits are adequate and provide for ongoing monitoring, reporting and control of credit risk; the adequacy of management information systems as it relates to credit risk; and the sufficiency of internal audit and independent review coverage of credit risk exposure.

- **Market risk**, which arises from exposures to movements in market prices as a result of underlying changes in, for example, interest rates, equity prices, foreign exchange rates, commodity prices, or real estate prices. The Federal Reserve will scope examination work based on a firm's level of inherent market risk exposure, which is normally driven by the primary business line(s) in which the firm is engaged as well as the structure of the investment portfolio. While interest rate risk (IRR) differs between insurance companies and banks, the degree of IRR also differs based on the type of insurance products the firm offers. IRR is a more significant risk factor for life insurers than for property/casualty (P/C) insurers since life and annuity products are often spread-based, longer in duration, may include embedded product guarantees, and can pose disintermediation risk. P/C insurers, especially property insurers, generally offer short-term contracts with the potential for frequent re-pricing, are subject to much less disintermediation risk. A firm may be exposed to inherent market risk due to its investment portfolio or as result of its product offerings, including variable and indexed life insurance

and annuity products, or asset/wealth management business. Generally foreign exchange and commodity risk is low for supervised insurance organizations but could exist for some complex firms. Firms are expected to have sound risk management infrastructure that adequately identifies, measures, monitors, and controls any material or significant forms of inherent market risks to which it is exposed.

- **Model risk** is the potential for adverse consequences from decisions based on incorrect or misused model outputs and reports. Model risk can lead to financial loss, poor business and strategic decision-making, or damage to a firm's reputation. Supervised insurance organizations are often heavily reliant on models for product pricing and reserving, risk and capital management, strategic planning and other decision-making purposes. A sound model risk management framework helps manage this risk.⁷ Federal Reserve examiners will take into account the firm's size, nature, and complexity, as well as the extent of use and sophistication of its models when assessing its model risk management program. Examiners focus on the governance framework, policies and controls, and aggregated model risk management through a holistic evaluation of the firm's practices. The Federal Reserve's review of a firm's model risk management program complements the work of the firm's other relevant supervisors. A sound model risk management framework includes three main elements: (1) an accurate model inventory and an appropriate approach to model development, implementation, and use; (2) effective model validation and continuous model performance monitoring; and (3) a strong governance framework that provides explicit support and structure for model risk management through policies defining relevant activities, procedures that implement those policies, allocation of resources, and mechanisms for evaluating whether policies and procedures are being carried out as specified, including internal audit review. The Federal Reserve will rely on work already conducted by other relevant supervisors and appropriately collaborate with the state insurance regulators on their findings related to insurance models. With respect to the business of insurance, Federal Reserve examiners focus on the firm's adherence to its own policies and

⁷ SR 11-7 *Guidance on Model Risk Management* is applicable to supervised insurance organizations.

procedures and the comprehensiveness of model validation rather than technical specifications such as the appropriateness of the model, its assumptions or output. The Federal Reserve may request that firms provide model documentation or model validation reports for insurance and bank models when performing transaction testing.

- **Legal risk** arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or financial condition of a supervised insurance organization. **Compliance risk** is the risk of regulatory sanctions, fines, penalties or losses resulting from failure to comply with laws, rules, regulations, or other supervisory requirements applicable to a firm. By offering multiple financial service products that may include insurance, annuity, banking, services provided by securities broker-dealers, and asset and wealth management products, provided through a diverse distribution network, supervised insurance organizations are inherently exposed to a significant amount of legal and compliance risk. As the consolidated supervisor, the Board expects firms to have an enterprise-wide legal and compliance risk management program that covers all business lines, legal entities, and jurisdictions of operation. Firms are expected to have compliance risk management governance, oversight, monitoring, testing, and reporting commensurate with their size and complexity, and to ensure compliance with applicable laws and regulations. The principles-based guidance in existing SR letters related to legal and compliance risk is applicable to supervised insurance organizations.⁸ For both complex and noncomplex firms, Federal Reserve examiners rely on the work of the firm's other supervisors. As described in section C, Incorporating the Work of Other Supervisors, the opinions, examination results, ratings, supervisory issues, and enforcement actions from other supervisors will be incorporated into a consolidated assessment of the enterprise-wide legal and compliance risk management framework.

⁸ SR 08-8 *Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles*, <https://www.federalreserve.gov/boarddocs/srletters/2008/SR0808.htm>, is applicable to complex supervised insurance organizations. For noncomplex firms, the Federal Reserve will assess legal and compliance risk management based on the guidance in SR 16-11 *Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than \$50 Billion*, <https://www.federalreserve.gov/supervisionreg/srletters/sr1611.htm>.

- Money laundering, terrorist financing and other illicit financial activity risk is the risk of providing criminals access to the legitimate financial system and thereby being used to facilitate financial crime. This financial crime includes laundering criminal proceeds, financing terrorism, and conducting other illegal activities. Money laundering and terrorist financing risk is associated with a financial institution's products, services, customers, and geographic locations. This and other illicit financial activity risks can impact a firm across business lines, legal entities, and jurisdictions. A reasonably designed compliance program generally includes a structure and oversight that mitigates these risks and supports regulatory compliance with both Bank Secrecy Act/Anti-Money Laundering (BSA/AML) and Office of Foreign Assets Control (OFAC) requirements. Although OFAC regulations are not part of the BSA, OFAC compliance programs are frequently assessed in conjunction with BSA/AML. Supervised insurance organizations are not defined as financial institutions under the BSA and, therefore, are not required to have an AML program, unless the firm is directly selling certain insurance products. However, certain subsidiaries and affiliates of supervised insurance organizations, such as insurance companies and banks, are defined as financial institutions under 31 U.S.C. 5312(a)(2) and must develop and implement a written BSA/AML compliance program as well as comply with other BSA regulatory requirements. Unlike banks, insurance companies' BSA/AML obligations are limited to certain products, referred to as covered insurance products.⁹ The volume of covered products, which the Financial Crimes Enforcement Network (FinCEN) has determined to be of higher risk, is an important driver of supervisory focus. In addition, as U.S. persons, all supervised insurance organizations (including their subsidiaries and affiliates) are subject to Office of Foreign Assets Control (OFAC) regulations. Federal Reserve examiners assess all material risks that each firm faces, extending to

⁹ "Covered products" means: a permanent life insurance policy, other than a group life insurance policy; an annuity contract, other than a group annuity contract; or any other insurance product with features of cash value or investment.

"Permanent life insurance policy" means an agreement that contains a cash value or investment element and that obligates the insurer to indemnify or to confer a benefit upon the insured or beneficiary to the agreement contingent upon the death of the insured. "Annuity contract" means any agreement between the insurer and the contract owner whereby the insurer promises to pay out a fixed or variable income stream for a period of time.

whether business activities across the consolidated organization, including within its individual subsidiaries or affiliates, comply with the legal requirements of BSA and OFAC regulations. In keeping with the principles of a risk-based framework and proportionality, Federal Reserve supervision for BSA/AML and OFAC primarily focuses on oversight of compliance programs at a consolidated level and relies on work by other relevant supervisors to the fullest extent possible. In the evaluation of a firm's risks and BSA/AML and OFAC compliance program, however, it may be necessary for examiners to review compliance with BSA/AML and OFAC requirements at individual subsidiaries or affiliates in order to fully assess material risks of the supervised insurance organization.

- ***Operational risk*** is the risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events. Operational resilience is the ability to maintain operations, including critical operations and core business lines, through a disruption from any hazard. It is the outcome of effective operational risk management combined with sufficient financial and operational resources to prepare, adapt, withstand, and recover from disruptions. A firm that operates in a safe and sound manner is able to identify threats, respond and adapt to incidents, and recover and learn from such threats and incidents so that it can prioritize and maintain critical operations and core business lines, along with other operations, services and functions identified by the firm, through a disruption.
 - ***Cybersecurity/information technology risks*** are a subset of operational risk and arise from operations of a firm requiring a strong and robust internal control system and risk management oversight structure. Information Technology (IT) and Cybersecurity (Cyber) functions are especially critical to firms' operations. Examiners of financial institutions, including supervised insurance organizations, find detailed guidance on mitigating these risks in the Federal Financial Institutions Examination Council's (FFIEC) IT Handbooks. In assessing IT/Cyber risks, Federal Reserve examiners will assess a firm's board and senior management for effective oversight and support of IT management; information/cyber security program for strong board and senior management support, integration of security activities and controls through business processes, and establishment of clear accountability for security

responsibilities; IT operations for sufficient personnel, system capacity and availability, and storage capacity adequacy to achieve strategic objectives and appropriate solutions: development and acquisition processes' ability to identify, acquire, develop, install, and maintain effective IT to support business operations; and appropriate business continuity management processes to effectively oversee and implement resilience, continuity, and response capabilities to safeguard employees, customers, assets, products, and services. Complex and noncomplex firms will be assessed in these areas. All supervised insurance organizations are expected to notify the Federal Reserve of any security breaches involving sensitive customer information, whether or not the institution notifies its customers.¹⁰

- ***Third party risk*** is also a subset of operational risk and arises from a firm's use of service providers to perform operational or service functions. These risks may be inherent to the outsourced activity or be introduced with the involvement of the service provider. When assessing effective third party risk management, Federal Reserve examiners will evaluate eight areas: 1) third party risk management governance, 2) risk assessment framework, 3) due diligence in the selection of a service provider, 4) a review of any incentive compensation embedded in a service provider contract, 5) management of any contract or legal issues arising from third party agreements, 6) ongoing monitoring and reporting of third parties, 7) business continuity and contingency of the third party for any service disruptions, and 8) effective internal audit program to assess the risk and controls of the firm's third party risk management program.¹¹

b. Capital Management

The Capital Management rating is derived from an assessment of a firm's current and stressed level of capitalization, and the quality of its capital planning and stress testing. A capital management program should be commensurate with a supervised

¹⁰ SR 05-23, Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice, applies to all supervised insurance organizations.

¹¹ *SR Letter 13-19, Guidance on Managing Outsourcing Risk*, <https://www.federalreserve.gov/supervisionreg/srletters/sr1319.htm>, applies to complex and noncomplex supervised insurance organizations.

insurance organization's complexity and unique risk profile. In assigning this rating, the Federal Reserve evaluates the extent to which a firm maintains sound capital planning practices through effective governance and oversight, effective risk management and controls, maintenance of updated capital policies and contingency plans for addressing potential shortfalls, and incorporation of appropriately stressful conditions into capital planning and projections of capital positions. The extent to which a firm's capital is sufficient to comply with regulatory requirements, to support the firm's ability to meet its obligations, and to enable the firm to remain a source of strength to its depository institution(s) in a range of stressful, but plausible, economic and financial environments is also evaluated.

Insurance company balance sheets are typically quite different from those of most banking organizations. For insurance companies, investment strategies focus on cash flow matching to reduce interest rate risk and provide liquidity to support their liabilities, while for traditional banks, deposits (liabilities) are attracted to support investment strategies. Additionally, for insurers, capital provides a buffer for policyholder claims and creditor obligations, helping the firm absorb adverse deviations in expected claims experience, and other drivers of economic loss. The Board recognizes that the capital needs for insurance activities are materially different from those of banking activities. Insurers also often face capital fungibility constraints not faced by banks.

In assessing a supervised insurance organization's capital management, the Federal Reserve relies to the fullest extent possible on information provided by the state insurance regulators, including the firm's ORSA and the state insurance regulator's written assessment of the ORSA. An ORSA is an internal process undertaken by an insurance group to assess the adequacy of its risk management and current and prospective capital position under normal and severe stress scenarios. As part of the ORSA, insurance groups are required to analyze all reasonably foreseeable and relevant material risks that could have an impact on their ability to meet obligations.

The Board expects supervised insurance organizations to have sound governance over their capital planning process.¹² A firm should establish capital goals that are

¹² SR 15-19: *Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category II and III Standards*, <https://www.federalreserve.gov/supervisionreg/>

approved by the board of directors, and that reflect the potential impact of legal and/or regulatory restrictions on the transfer of capital between legal entities. In general, senior management should establish the capital planning process, which should be reviewed and approved periodically by the board. The board should require senior management to provide clear, accurate, and timely information on the firm's material risks and exposures to inform board decisions on capital adequacy and actions. The capital planning process should clearly reflect the difference between the risk profiles and associated capital needs of the insurance and banking businesses.

A firm should have a risk management framework that appropriately identifies, measures, and assesses material risks and provides a strong foundation for capital planning. This framework should be supported by comprehensive policies and procedures, clear and well-established roles and responsibilities, strong internal controls, and effective reporting to senior management and the board. In addition, the risk management framework should be built upon sound management information systems.

As part of capital management, a firm should have a sound internal control framework that helps ensure that all aspects of the capital planning process are functioning as designed and result in accurate assessments of the firm's capital needs. The framework should include an independent internal audit function as well as other review functions with appropriate staff expertise, experience, and stature in the organization to monitor the adequacy of capital risk measurement and management processes.

The governance and oversight framework should include a written assessment of the principles and guidelines used for capital planning, issuance, and usage, including internal post-stress capital goals and targeted capital levels; guidelines for dividend payments and stock repurchases; strategies for addressing capital shortfalls; and internal governance responsibilities and procedures for the capital policy. The capital policy should reflect the unique capital needs of the insurance and banking businesses based on their risks, be approved by the firm's board of directors or a designated committee of the board, and be re-evaluated periodically and revised as necessary.

[srletters/sr1519.htm](https://www.federalreserve.gov/srletters/sr1519.htm), is applicable to complex supervised insurance organizations, however, Federal Reserve focuses on the sections most relevant for these firms. For example, references to pre-provision net revenue (PPNR) modeling and risk-weighted asset (RWA) projections are not applicable to supervised insurance organizations.

A strong capital management program will incorporate appropriately stressful conditions and events that could adversely affect the firm's capital adequacy and capital planning. As part of its capital plan, a firm should use at least one scenario that stresses the specific vulnerabilities of the firm's activities and associated risks, including those related to the firm's insurance activities and its banking activities.

Supervised insurance organizations should employ estimation approaches that allow them to project the impact on capital positions of various types of stressful conditions and events, and that are independently validated. A firm should estimate losses, revenues, expenses, and capital using a sound method that incorporates macroeconomic and other risk drivers. The robustness of a firm's capital stress testing processes should be commensurate with the to its capital position.

c. Liquidity Management

The Liquidity Management rating is derived from an assessment of the supervised insurance organization's liquidity position and the quality of its liquidity risk management program. Each firm's liquidity risk management program should be commensurate with its complexity and unique risk profile.

The Board recognizes that insurance companies are typically less exposed to traditional liquidity risk than are banks. Traditional banking activity involves a liquidity transformation of liquid demand deposits into an asset on a banking organization's balance sheet, notably from the perspective of liquidity risk, illiquid bank loans. In traditional insurance business, the fact that an occurrence of an insured event is required for a claim payment, helps reduce liquidity risk. Insurers minimize liquidity risk by attempting to match expected asset cash flows against expected claims payments. The Board's expectations for supervised insurance organizations recognize and reflect this difference in inherent liquidity risk.

The Board, however, does expect all depository institution holding companies, including supervised insurance organizations, to adhere to basic principles for managing liquidity risk.¹³

¹³ For an explanation of these principles, see SR Letter 10-6, *Interagency Policy Statement on Funding and Liquidity Risk Management*, <https://www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm>.

The Federal Reserve's supervision of supervised insurance organizations focuses on the sections of SR 10-6 that are most relevant to the liquidity characteristics of these firms. For example, guidance on intra-day liquidity management would only be applicable for supervised insurance organizations with material intra-day liquidity risks. Additionally, specific references to liquid assets in SR 10-6 may be more broadly interpreted to include other asset classes such as certain investment-grade corporate bonds.

The intensity of the Federal Reserve's supervisory focus on liquidity risk is influenced by each firm's individual risk profile. Traditional property and casualty insurance products are typically short duration liabilities backed by short-duration, liquid assets. Because of this, they typically present less liquidity risk than traditional banking products. However, some non-traditional life insurance and retirement products create liquidity risk through features that allow payments at the request of policyholders without the occurrence of an insured event. Risks of certain other insurance products are often mitigated using derivatives. Any differences between collateral requirements related to hedging and the related liability cash flows can also create liquidity risk. The Board expects firms significantly engaged in these types of insurance activities to have correspondingly more sophisticated liquidity risk management programs.

A strong liquidity risk management program includes comprehensive cash flow forecasting with appropriate granularity, preferably for each major legal entity as well as for the consolidated enterprise. The firm's suite of quantitative metrics should effectively inform senior management and the board of directors of the firm's unique liquidity risk profile and identify liquidity events or stresses that could detrimentally affect the firm. The metrics used to measure a firm's liquidity position may vary by type of business.

Federal Reserve examiners rely to the fullest extent possible on each firm's ORSA, which requires all firms to include a discussion of the risk management framework and assessment of material risks, including liquidity risk.

Supervised insurance organizations are expected to perform liquidity stress testing at least annually and more frequently if necessary, based on their risk profile. The scenarios used should reflect the firm's specific risk profile and include both idiosyncratic and system-wide stress events. Stress testing should

inform the firm on the amount of liquid assets necessary to meet net cash outflows over relevant time periods, including at least a one-year time horizon. Firms should hold a liquidity buffer comprised of highly liquid assets to meet stressed net cash outflows. The liquidity buffer should be measured using appropriate haircuts based on asset quality, duration, and expected market illiquidity based on the stress scenario assumptions. Stress testing should reflect the expected impact on collateral requirements.

Fungibility of liquidity is often limited between an insurance group's legal entities. Large insurance groups can operate with a significant number of legal entities and many different regulatory and operational barriers to transferring funds among them. Regulations designed to protect policyholders of insurance operating companies can limit the transferability of funds from an insurance company to other legal entities within the group, including to other insurance operating companies. Supervised insurance organizations should carefully consider these limitations in their stress testing and liquidity risk management framework. Effective liquidity stress testing should include stress testing at the legal entity level with consideration for intercompany liquidity fungibility. Furthermore, the firm should be able to measure and provide an assessment of liquidity at the top-tier depository institution holding company in a manner that incorporates fungibility constraints.

The enterprise-wide governance and oversight framework should be consistent with the firm's liquidity risk profile and include policies and procedures on liquidity risk management. Policies and procedures should detail the oversight of liquidity risk through a specific document such as a Liquidity Policy. Policies and procedures should include the frequency of liquidity reporting and stress testing. Stress testing results should be communicated clearly and regularly to senior management and the board. A comprehensive contingency funding plan, commensurate with the firm's categorization and liquidity risk profile, should be maintained to manage liquidity stress events. The contingency funding plan should detail specific policies, procedures, and actions for addressing liquidity stress events or breaches of liquidity risk limits.

Supervised insurance organizations should also have an enterprise-wide approach for the control and oversight of liquidity risk. This should include

management committee reporting of liquidity risk, governance, and assumptions for key elements of liquidity risk management such as stress testing and the firm's liquidity risk appetite, among others. The risk appetite statement, which should be approved by the board of directors, should detail and define the level of impact of a liquidity event or stress that the firm can. Additionally, the governance framework should detail the process and policies around liquidity risk identification, measurement, and risk-mitigating actions.

B. Supervisory Ratings

Supervised insurance organizations are expected to operate in a safe and sound manner, to comply with all applicable laws and regulations, and to possess sufficient financial and operational strength to serve as a source of strength for their depository institution(s) through a range of stressful yet plausible conditions. Supervisory ratings and supervisory findings are used to communicate the assessment of a firm. Each year, the Federal Reserve examiners assign one of four ratings to each of the three rating components used to assess supervised insurance organizations. The rating components are Capital Management, Liquidity Management, and Governance & Controls. The four potential ratings are Broadly Meets Expectations, Conditionally Meets Expectations, Deficient-1, and Deficient-2. To be considered "well managed," a firm must receive a rating of Conditionally Meets Expectations or better in each of the three rating components. Each rating is defined specifically for supervised insurance organizations with particular emphasis on the obligation that firms serve as a source of financial and managerial strength for their depository institution(s). High-level definitions for each rating are below, followed by more specific rating definitions for each component.

Broadly Meets Expectations: The supervised insurance organization's practices and capabilities broadly meet supervisory expectations. The holding company effectively serves as a source of managerial and financial strength for its depository institution(s) and possesses sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of stressful yet plausible conditions. The firm may have outstanding supervisory issues requiring corrective actions, but these are unlikely to present a threat to its ability to maintain safe-and-sound operations and unlikely to negatively impact its ability to fulfill its obligation to serve as a source of strength for its depository

institution(s). These issues are also expected to be corrected on a timely basis during the normal course of business.

Conditionally Meets Expectations: The supervised insurance organization’s practices and capabilities are generally considered sound. However, certain supervisory issues are sufficiently material that if not resolved in a timely manner during the normal course of business, may put the firm’s prospects for remaining safe and sound, and/or the holding company’s ability to serve as a source of managerial and financial strength for its depository institution(s), at risk. A firm rated “Conditionally Meets Expectations” has the ability, resources, and management capacity to resolve its issues and has developed a sound plan to address the issue(s) in a timely manner. Examiners will work with the firm to develop an appropriate timeframe during which it will be required to resolve that supervisory issue(s) leading to this rating.

Deficient-1: Financial or operational deficiencies in a supervised insurance organization’s practices or capabilities put its prospects for remaining safe and sound, and/or the holding company’s ability to serve as a source of managerial and financial strength for its depository institution(s), at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require it to make material changes to its business model or financial profile, or its practices or capabilities. A firm with a Deficient-1 rating is required to take timely action to correct financial or operational deficiencies and to restore and maintain its safety and soundness and compliance with laws and regulation. Supervisory issues that place the firm’s safety and soundness at significant risk, and where resolution is likely to require steps that clearly go beyond the normal course of business – such as issues requiring a material change to the firm’s business model or financial profile, or its governance, risk management or internal control structures or practices – would generally warrant assignment of a Deficient-1 rating. There is a strong presumption that a firm with a Deficient-1 rating will be subject to an enforcement action.

Deficient-2: Financial or operational deficiencies in a supervised insurance organization’s practices or capabilities present a threat to its safety and soundness, have already put it in an unsafe and unsound condition, and/or make it unlikely that the holding company will be able to serve as a source of financial and managerial strength to its depository institution(s). A firm with a Deficient-2 rating is required to immediately implement comprehensive corrective measures and demonstrate the sufficiency of contingency planning in the event of

further deterioration. There is a strong presumption that a firm with a Deficient-2 rating will be subject to a formal enforcement action.

Definitions for the Capital Management Component Rating:

Broadly Meets Expectations: Despite the potential existence of outstanding supervisory issues, the supervised insurance organization's capital management broadly meets supervisory expectations, supports maintenance of safe-and-sound operations, and supports the holding company's ability to serve as a source of financial strength for its depository institution(s). Specifically:

- The firm's current and projected capital positions on a consolidated basis and within each of its material business lines/legal entities comply with regulatory requirements and support its ability to absorb potential losses, meet obligations, and continue to serve as a source of financial strength for its depository institution(s);
- Capital management processes are sufficient to give credibility to stress testing results and the firm is capable of producing sound assessments of capital adequacy through a range of stressful yet plausible conditions; and
- Potential capital fungibility issues are effectively mitigated, and capital contingency plans allow the holding company to continue to act as a source of financial strength for its depository institution(s) through a range of stressful yet plausible conditions.

Conditionally Meets Expectations: Capital adequacy meets regulatory minimums, both currently and on a prospective basis. Supervisory issues exist but these do not threaten the holding company's ability to act as a source of financial strength for its depository institution(s) through a range of stressful yet plausible conditions. Specifically, if left unresolved, these issues:

- May threaten the firm's ability to produce sound assessments of capital adequacy through a range of stressful yet plausible conditions; and/or
- May result in the firm's projected capital positions being insufficient to absorb potential losses, comply with regulatory requirements, and support the holding company's ability to meet current and prospective obligations and continue to serve as a source of financial strength to its depository institution(s).

Deficient-1: Financial or operational deficiencies in a supervised insurance organization's capital management put its prospects for remaining safe and sound through a range of plausible conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require a material change to the firm's business model or financial profile, or its capital management processes.

Examples of issues that may result in a Deficient-1 rating include, but are not limited to:

- Capital adequacy currently meets regulatory minimums although there may be uncertainty regarding the firm's ability to continue meeting regulatory minimums.
- Fungibility concerns may exist that could challenge the firm's ability to contribute capital to its depository institutions under certain stressful yet plausible scenarios.
- Supervisory issues may exist that undermine the credibility of the firm's current capital adequacy and/or its stress testing results.

Deficient-2: Financial or operational deficiencies in a supervised insurance organization's capital management present a threat to the firm's safety and soundness, a threat to the holding company's ability to serve as a source of financial strength for its depository institution(s), or have already put the firm in an unsafe and unsound condition.

Examples of issues that may result in a Deficient-2 rating include, but are not limited to:

- Capital adequacy may currently fail to meet regulatory minimums or there is significant concern that the firm will not meet capital adequacy minimums prospectively.
- Supervisory issues may exist that significantly undermine the firm's capital adequacy metrics either currently or prospectively.
- Significant fungibility constraints may exist that would prevent the holding company from contributing capital to its depository institution(s) and fulfilling its obligation to serve as a source of financial strength.
- The holding company may have failed to act as source of financial strength for its depository institution when needed.

Definitions for the Liquidity Management Component Rating:

Broadly Meets Expectations: Despite the potential existence of outstanding supervisory issues, the supervised insurance organization's liquidity management broadly meets supervisory expectations, supports maintenance of safe-and-sound operations, and supports the holding company's ability to serve as a source of financial strength for its depository institution(s). The firm generates sufficient liquidity to meet its short-term and long-term obligations currently and under a range of stressful yet plausible conditions. The firm's liquidity management processes, including its liquidity contingency planning, support its obligation to act as a source of financial strength for its depository institution(s).

Specifically:

- The firm is capable of producing sound assessments of liquidity adequacy through a range of stressful yet plausible conditions; and
- The firm's current and projected liquidity positions on a consolidated basis and within each of its material business lines/legal entities comply with regulatory requirements and support the holding company's ability to meet obligations and to continue to serve as a source of financial strength for its depository institution(s).

Conditionally Meets Expectations: Certain material financial or operational weaknesses in a supervised insurance organization's liquidity management place its prospects for remaining safe and sound through a range of stressful yet plausible conditions at risk if not resolved in a timely manner during the normal course of business.

Specifically, if left unresolved, these weaknesses:

- May threaten the firm's ability to produce sound assessments of liquidity adequacy through a range of conditions; and/or
- May result in the firm's projected liquidity positions being insufficient to comply with regulatory requirements and support the firm's ability to meet current and prospective obligations and to continue to serve as a source of financial strength to its depository institution(s).

Deficient-1: Financial or operational deficiencies in a supervised insurance organization's liquidity management put the firm's prospects for remaining safe and sound through a range of stressful yet plausible conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require a material change to the firm's business model or financial profile, or its liquidity management processes.

Examples of issues that may result in a Deficient-1 rating include, but are not limited to:

- The firm is currently able to meet its obligations but there may be uncertainty regarding the firm's ability to do so prospectively.
- The holding company's liquidity contingency plan may be insufficient to support its obligation to act as a source of financial strength for its depository institution(s).
- Supervisory issues may exist that undermine the credibility of the firm's liquidity metrics and stress testing results.

Deficient-2: Financial or operational deficiencies in a supervised insurance organization's liquidity management present a threat to its safety and soundness, a threat to the holding company's ability to serve as a source of financial strength for its depository institution(s), or have already put the firm in an unsafe and unsound condition.

Examples of issues that may result in a Deficient-2 rating include, but are not limited to:

- Liquidity shortfalls may exist within the firm that have prevented the firm, or are expected to prevent the firm, from fulfilling its obligations, including the holding company's obligation to act as a source of financial strength for its depository institution(s).
- Liquidity adequacy may currently fail to meet regulatory minimums or there is significant concern that the firm will not meet liquidity adequacy minimums prospectively for at least one of its regulated subsidiaries.
- Supervisory issues may exist that significantly undermine the firm's liquidity metrics either currently or prospectively.
- Significant fungibility constraints may exist that would prevent the holding company from supporting its depository institution(s) and fulfilling its obligation to serve as a source of financial strength.
- The holding company may have failed to act as source of financial strength for its depository institution when needed.

Definitions for the Governance and Controls Component Rating:

Broadly Meets Expectations: Despite the potential existence of outstanding supervisory issues, the supervised insurance organization's governance and controls broadly meet

supervisory expectations, supports maintenance of safe-and-sound operations, and supports the holding company's ability to serve as a source of financial and managerial strength for its depository institution(s). Specifically, the firm's practices and capabilities are sufficient to align strategic business objectives with its risk appetite and risk management capabilities, maintain effective and independent risk management and control functions, including internal audit; promote compliance with laws and regulations; and otherwise provide for the firm's ongoing financial and operational resiliency through a range of conditions. The firm's governance and controls clearly reflect the holding company's obligation to act as a source of financial and managerial strength for its depository institution(s).

Conditionally Meets Expectations: Certain material financial or operational weaknesses in a supervised insurance organization's governance and controls practices may place the firm's prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business. Specifically, if left unresolved, these weaknesses may threaten the firm's ability to align strategic business objectives with its risk appetite and risk-management capabilities; maintain effective and independent risk management and control functions, including internal audit; promote compliance with laws and regulations; or otherwise provide for the firm's ongoing resiliency through a range of conditions. Supervisory issues may exist related to the firm's internal audit function, but internal audit is still regarded as effective.

Deficient-1: Deficiencies in a supervised insurance organization's governance and controls put its prospects for remaining safe and sound through a range of conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require a material change to the firm's business model or financial profile, or its governance, risk management or internal control structures or practices.

Examples of issues that may result in a Deficient-1 rating include, but are not limited to:

- The firm may be currently subject to, or expected to be subject to, informal or formal enforcement action(s) by the Federal Reserve or another regulator tied to violations of laws and regulations.
- Significant legal issues may have or be expected to impede the holding company's ability to act as a source of financial strength for its depository institution(s).
- The firm may have engaged in intentional misconduct.

- Deficiencies within the firm's governance and controls may limit the credibility of the firm's financial results, limit the board or senior management's ability to make sound decisions, or materially increase the firm's risk of litigation.
- The firm's internal audit function may be considered ineffective.
- Deficiencies in the firm's governance and controls may have limited the holding company's ability to act as a source of financial and/or managerial strength for its depository institution(s).

Deficient-2: Financial or operational deficiencies in a supervised insurance organization's governance and controls present a threat to its safety and soundness, a threat to the holding company's ability to serve as a source of financial strength for its depository institution(s), or have already put the firm in an unsafe and unsound condition.

Examples of issues that may result in a Deficient-2 rating include, but are not limited to:

- The firm is currently subject to, or expected to be subject to, formal enforcement action(s) by the Federal Reserve or another regulator tied to violations of laws and regulations.
- Significant legal issues may be impeding the holding company's ability to act as a source of financial strength for its depository institution(s).
- The firm may have engaged in intentional misconduct.
- The holding company may have failed to act as a source of financial and/or managerial strength for its depository institution(s) when needed.
- The firm's internal audit function is regarded as ineffective.

C. Incorporating the Work of Other Supervisors

Similar to the approach taken by the Federal Reserve in its consolidated supervision of other firms, the supervision of supervised insurance organizations relies, to the fullest extent possible, on work done by other relevant supervisors. The Federal Reserve collaboratively coordinates with, communicates with, and leverages the work of the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Financial Crimes Enforcement Network (FinCEN), Internal Revenue Service (IRS), applicable state insurance regulators, and other relevant supervisors to achieve its supervisory objectives and eliminate unnecessary burden.

Existing statutes specifically require the Board to coordinate with, and to rely to the fullest extent possible on work by the state insurance regulators. The Board and all state insurance regulators have entered into Memorandums of Understanding (MOU) allowing supervisors to freely exchange information relevant for the effective supervision of supervised insurance organizations. Federal Reserve examiners take the actions below with respect to state insurance regulators to support accomplishing the objective of minimizing supervisory duplication and burden, without sacrificing effective oversight:

- Routine discussions with state insurance regulatory staff with greater frequency during times of stress;
- Discussions around the annual supervisory plan, including how best to leverage work done by the state and potential participation by state insurance regulatory staff on relevant supervisory activities;
- Consideration of the opinions and work done by the state when scoping relevant examination activities;
- Documenting any input received from the state and consideration given to the opinions and work done by the state for relevant supervisory activities;
- Sharing and discussing with the state the annual ratings and relevant conclusion documents from supervisory activities;
- Collaboratively working with the states and the National Association of Insurance Commissioners (NAIC) on the development of policies that affect insurance depository institution holding companies; and
- Participating in supervisory colleges.

The Federal Reserve relies on the state insurance regulators to participate in the activities above and to share proactively their supervisory opinions and relevant documents. These documents include the annual Own Risk Solvency Assessment (ORSA),¹⁴ the state insurance regulator's written assessment of the ORSA, results from its examination activities, the Corporate Governance Annual Disclosure, and other state supervisory material. If the Federal Reserve determines that it is necessary to perform supervisory activities related to

¹⁴ Nat'l Ass'n of Ins. Comm'rs, Own Risk and Solvency Assessment (ORSA) Guidance Manual 9 (December 2017), https://www.naic.org/store/free/ORSA_manual.pdf.

aspects of the supervised insurance organization that also fall under the jurisdiction of the state insurance regulator, it will communicate the rationale and result of these activities to the state insurance regulator.

By order of the Board of Governors of the Federal Reserve System.

Ann Misback,
Secretary of the Board.

Billing Code: 6210-01P

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